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Industry

Congressional

Committee on Transportation and Infrastructure

The following is our prepared testimony for the US House of Representatives Committee on Transportation and Infrastructure.

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Executive Summary

The problem with conspiracies

The problem with conspiracy theories or talk of price gouging is that it gives the oil companies far more control than they actually have. Certainly, during the recent run in crude oil and gasoline prices, the oil companies have become much more of price takers than price makers.

Part of the paradox of the oil markets has been the breakdown of expected elasticities and the emergence of reverse elasticities. Prior to joining Deutsche Bank in 2005, I was employed as a reservoir engineer at ExxonMobil. From my perspective on both sides of the table, we believe that both sides have got the oil price terribly wrong – with ExxonMobil doing a worse job of predicting the price of oil than Wall Street - but just barely.

Decades of low returns and underinvestment during the low oil price 1980's and 1990's has left the industry playing catch up, both in terms of resource under development and in terms of qualified personnel able to meet the new challenges. Higher prices, rather than increasing supply, has actually further constrained it. While new unconventional sources have become economic, resource nationalism around the globe has restricted International Oil Company access to less than 20% of the world's reserves and rising fiscal takes (including the US) has driven up the cost of doing business, or eliminated access all together in some cases. An incredibly tight global service and construction industry has further exaggerated both the cost and time of doing business.

Reverse elasticity of demand has also seen global demand increase with higher prices in major oil producing nations, driven by a combination of rapid demographic growth, subsidized oil prices and higher revenue in oil producing nations that allow governments to continue to provide cheap oil to local populations.

The resulting run up in the price of crude has driven up the price of gasoline as well, although not as much as one might expect. 2007 saw record refining margins as stretched US capacity, operational outages, strong demand and legislative mandates pushed inventories to recent lows. We testified last year that high gasoline prices would cure high gasoline prices, and weakening demand *has* proved to minimize the damage to the American consumer this year. When we broke $3.00/gal gasoline in 2007, crude oil cost $1.58/gal, with refining margins adding an additional $0.83/gal and taxes making up the other $0.60/gal. Today, crude oil is priced at $2.85/gal, with refining margins making up only $0.18/gal and tax the remainder. At times, gasoline has been manufactured for free.

Diesel, which has typically priced at a discount to gasoline, is subject to the same global supply trends as crude. The dieselization of the European automobile fleet has increased diesel demand relative to gasoline in recent years, while strong demand growth in developing nations has driven growth for both transport diesel as well as industrial users. US refining capacity, which is maximized to produce gasoline, not diesel, will respond with additional capital investment, but it will take time.

Efforts by the government to intervene typically have unintended consequences on all sides. In a tight global balance, the government through ULSD and ethanol has mandated tougher-to-make fuels, requiring more refining and plant maintenance. Suggestions for windfall profit taxes would further raise the cost of supply, while a suspension of the gasoline tax in summertime would only serve to artificially increase demand for gasoline (the wrong solution) while robbing the government of infrastructure revenue.

Ethanol is not a solution. The ethanol “methadone” simply subsidies farmers to grow corn for ethanol using oil-based fertilizer driving oil-powered tractors and serves to make this economic using government/taxpayer’s money. Ultimately ethanol subsidy lowers the pump price of gasoline and effectively encourages the cheap gasoline addiction.

US policy makers must stop attempting to re-create a 20th century of abundant and cheap US gasoline, it is as dead as the geology that leaves no more cheap US oil. Avoid additional mandates and allow the market to direct capital towards the areas of tightness – in this case diesel capacity. It is vital to allow US gasoline prices to reflect the true cost of supply, which even now they arguably do not do (poor geopolitics, the suffering environment).

Paradox, not conspiracy

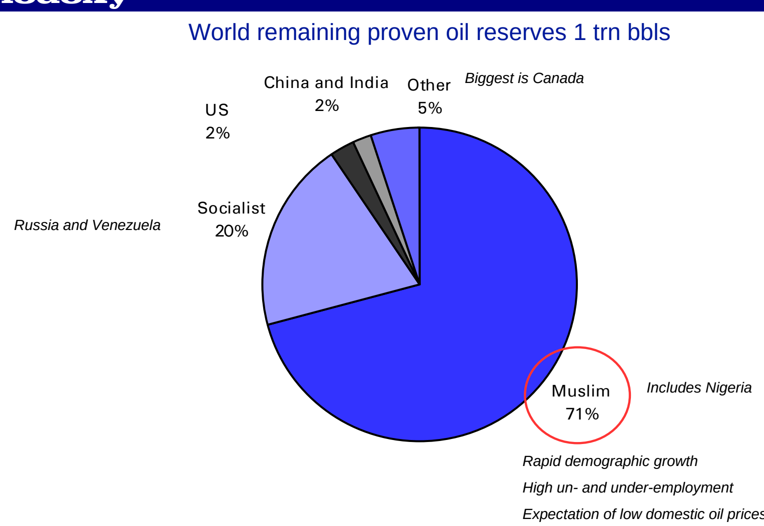
The challenge of traditional elasticities

The problem with conspiracy theories is that it assumes that the oil companies are in control. However, the reality is that they have become more of price takers than price makers. The run up of crude oil prices over the past four years has dumped much of conventional economic wisdom on its head as higher prices have worked to lower supply and increase demand.

Lower supply and higher demand

As oil prices have risen, so has the access of International oil companies to reserves decreased. Resource nationalism has cut off access to reserves in most of the Middle East, Russia and parts of South America. Empowered producing countries across the globe have re-written fiscal policy to receive a higher take, raising the cost of supply in the process. The US has not been immune, raising fiscal take, threatening windfall profit taxes and seeking to place ever more acreage out of reach of drilling.

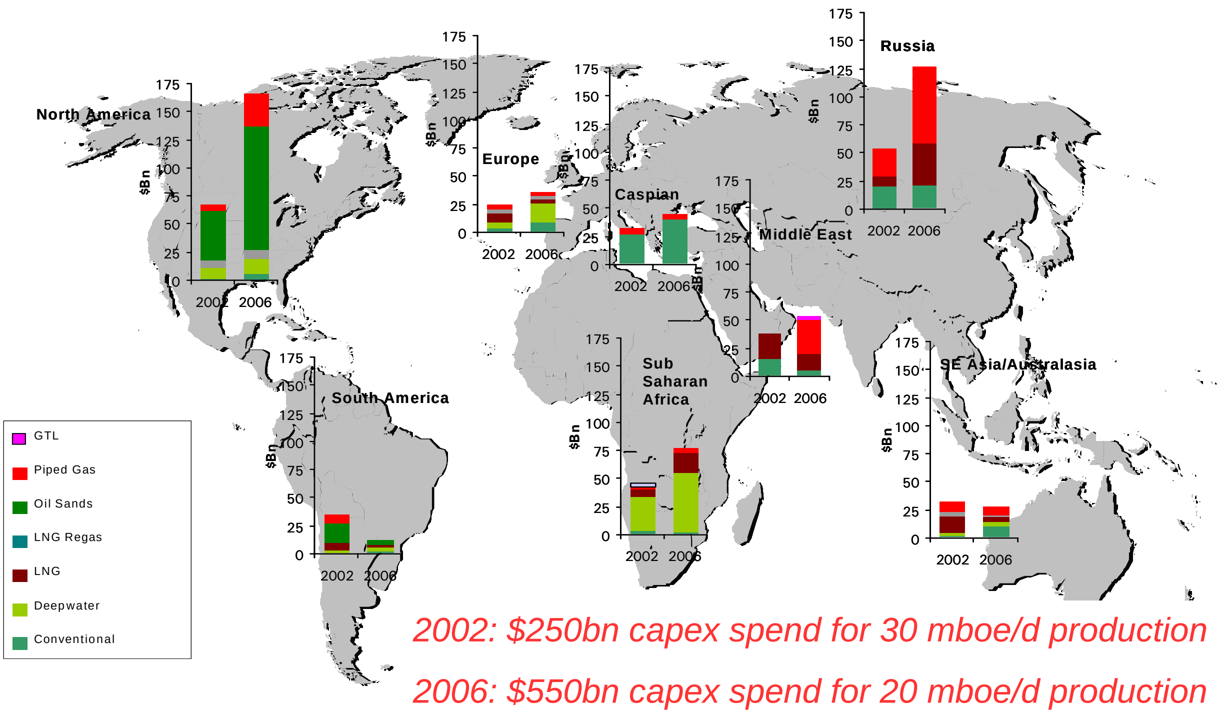
Figure 1: Remaining global oil reserves by orthodoxy



Source: BP, IMF, Deutsche Bank

While the oil and gas industry has significantly ramped up spending, both upstream and downstream, ability to reinvest is somewhat constrained. In addition to the resource nationalism mentioned above, a shortage of trained personnel has left the industry operating near the limits of its ability to reinvest capital, tougher geology is has left remaining reserves in ever more challenging and expensive locations, and a tight global service and construction industry has driven the cost of production to record levels. As a result, a rise in planned capital spending by the global integrated majors of 220% between 2002 and 2006, would develop 33% less total reserves – and it's only gotten worse.

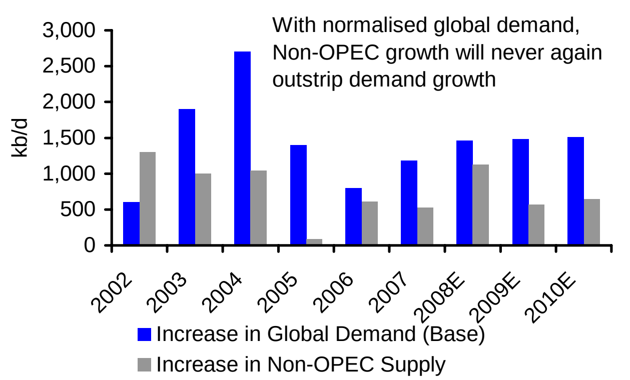
Figure 2: Between '02 and '06, capex spend rose 220% to generate 33% less production



Source: Deutsche Bank, Wood Mackenzie

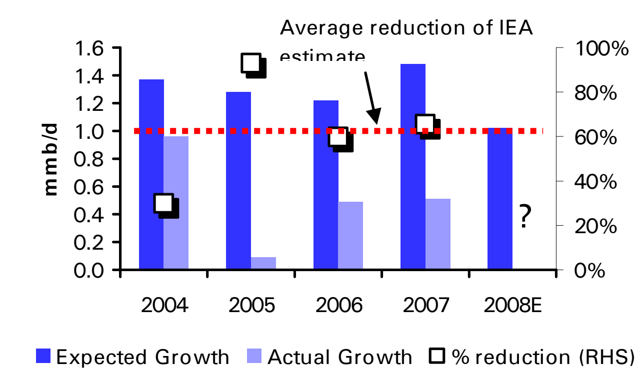
As a result, as a global economic boom, not least in China and India, has driven demand growth for all commodities, including oil, supply has an increasingly difficult time keeping up. Only once since 2000 has Non-OPEC supply growth exceeded demand growth. Despite robust forecasts for increasing supply, few believe the numbers. In recent years, growth has inevitably disappointed for a variety of the reasons cited above, with annual supply growth only averaging 40% of that forecasted a year earlier.

Figure 3: Demand growth vs Non-OPEC supply growth



Source: Deutsche Bank, IEA

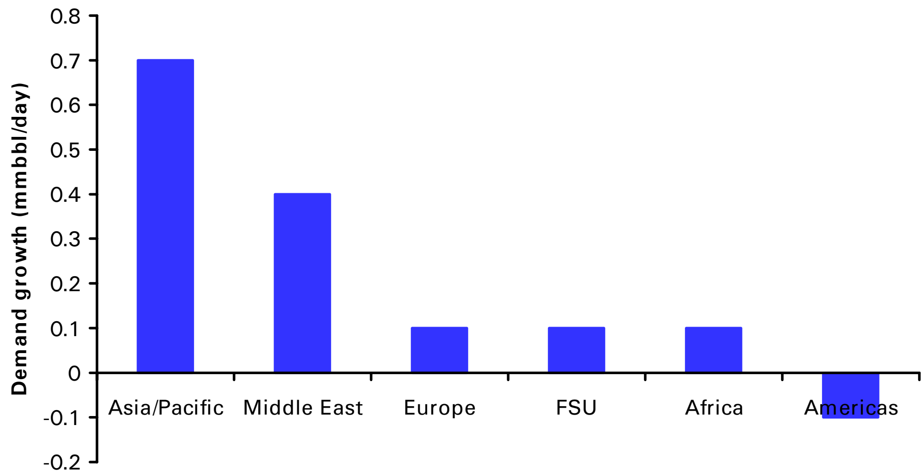
Figure 4: Downgrades in Non-OPEC supply outlook



Source: Deutsche Bank, IEA

The paradox of demand is that in much of the world, we have seen reverse elasticity with higher prices resulting in higher demand. Rapid demographic growth combined with subsidized prices and higher oil prices that allow governments to continue to provide cheap oil to local populations. It is no coincidence that nearly half of 2008 estimated demand growth will be from the Middle East, with the other half driven by China and India.

Figure 5: Breakdown of 2008 estimated demand growth, YOY



Source: IEA

While fundamentals are seen to be softening in the next couple of months, the steady stream of negative news on the supply side – declining production in Mexico, downgrades to Russian growth forecasts, Nigerian unrest, North Sea strikes, etc. – increase doubt that this looseness will materialize. This keeps spare capacity at uncomfortably low levels, increasing the risk priced into the commodity for future supply uncertainty (geopolitical, geologic, etc.).

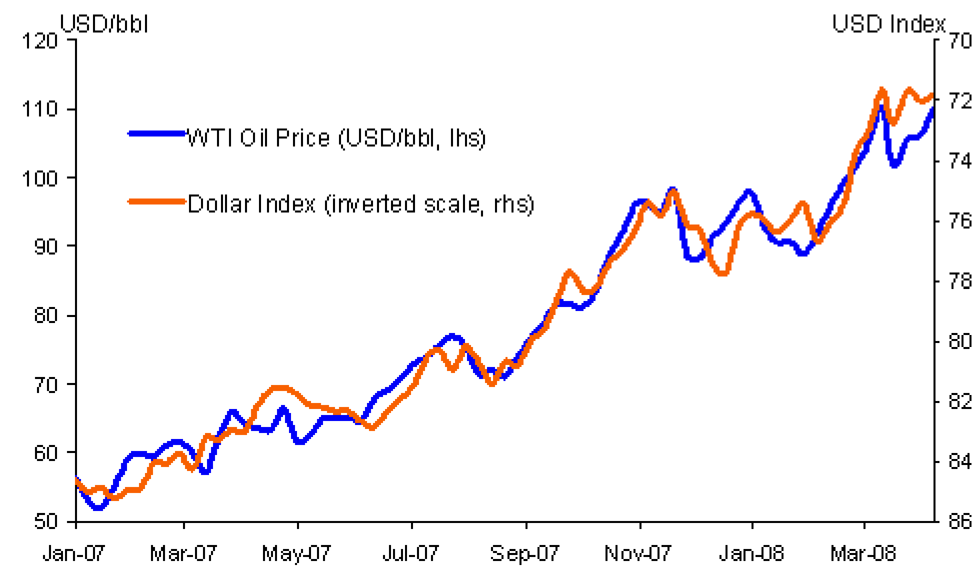
Longer term, the market is pricing in the inability of supply growth to meet the rising global demand. With supply challenged, the only solution is to increase the price to sufficient levels to destroy demand. In a country with a consumption problem, higher prices are your friend and more accurately reflect the true cost of energy supply (energy security, environmental, etc.).

The best thing the government can do is allow the markets to allocate capital effectively to adjust to current realities. US policy makers trying to re-create a 20th century of abundant and cheap US gasoline is a pipe dream, only serving to artificially increase the demand for gasoline, when it should be doing the opposite.

The US dollar

Further aggravating the problem in the past year has been a slowing US economy and US fiscal/monetary policy that has put the US dollar in freefall, reaching a recent all-time low against the euro. While prices have dramatically increased 230% in the US since January 2007, the rest of the world has seen a much more muted rise. Producing nations, whose costs are often in euro with their revenue in dollars have seen their earnings power reduced, while investors have bought crude and other commodities as a hedge against inflation.

Figure 6: US dollar vs. crude price



Source: Deutsche Bank, Bloomberg

Gasoline

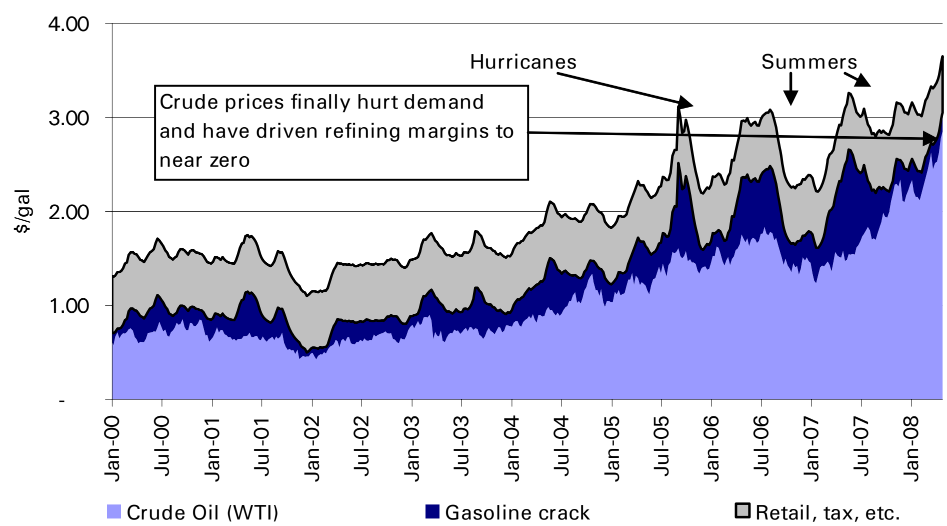
It's the crude

Last year we testified before the Senate on the realities of the gasoline market. Despite cries of price gouging, a combination of continued demand strength, low inventories, and weak supply drove gasoline prices over $3.00/gal. Some of this was the result of US government policies, which added additional complexity into an already stretched US refining system with the mandates of Ultra Low Sulfur Diesel and ethanol blending.

Despite the higher prices, we witnessed surprisingly little demand response over the past four years. In gasoline terms, we tested the equivalent of $100/bbl crude oil at various points between 2005 and 2008, often driven by externalities such as hurricanes, refinery accidents or introduction of government mandates. The current combination of high prices and a slowing national economy are finally impacting demand, with current motor gasoline demand down nearly 1% vs. this time in 2007.

While weakening demand has helped to mitigate rising prices, the cost of crude oil has set the floor for gasoline pricing. When we broke $3.00/gal gasoline in 2007, crude oil cost $1.58/gal, with refining margins adding an additional $0.83/gal and taxes making up the other $0.60/gal. Today, crude oil is priced at $2.85/gal, with refining margins making up only $0.18/gal and tax the remainder – with refiners actually losing money with each barrel refined at times.

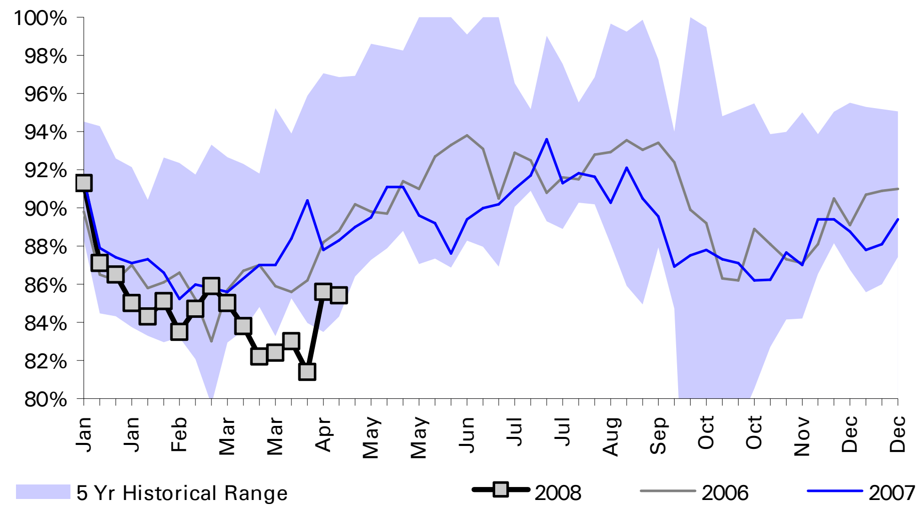
Figure 7: Crude finally drives gasoline to a demand tipping point



Source: Deutsche Bank

Although demand is falling, refining supply, which was uncharacteristically low in 2007 has remained low so far in 2008. Last year we testified that extended periods of maintenance - caused by tighter fuel specs, shortage of skilled contract workers and machinery pushed to the limit by strong demand – were partly to blame for the low utilization rates. Safety concerns in the wake of the Texas City disaster further contributed to a tightening of supply.

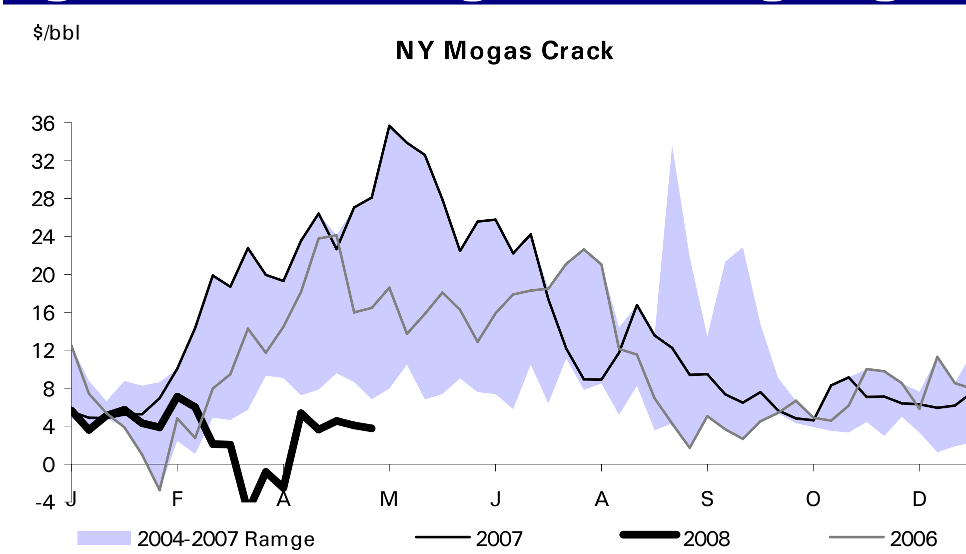
Figure 8: US refinery utilization



Source: US Department of Energy – Energy Information Agency, Deutsche Bank

This year, an additional factor has tightened supply: economics. Record crude prices and weakening demand in the US has created NEGATIVE gasoline margins at times over the last 3 months. This means that for each gallon of gasoline produced, *prior* to operating expense, a refiner is losing money. Pricing for bottom of the barrel products, such as asphalt and residual oil has been even worse.

Figure 9: US Gulf Coast gasoline refining margin



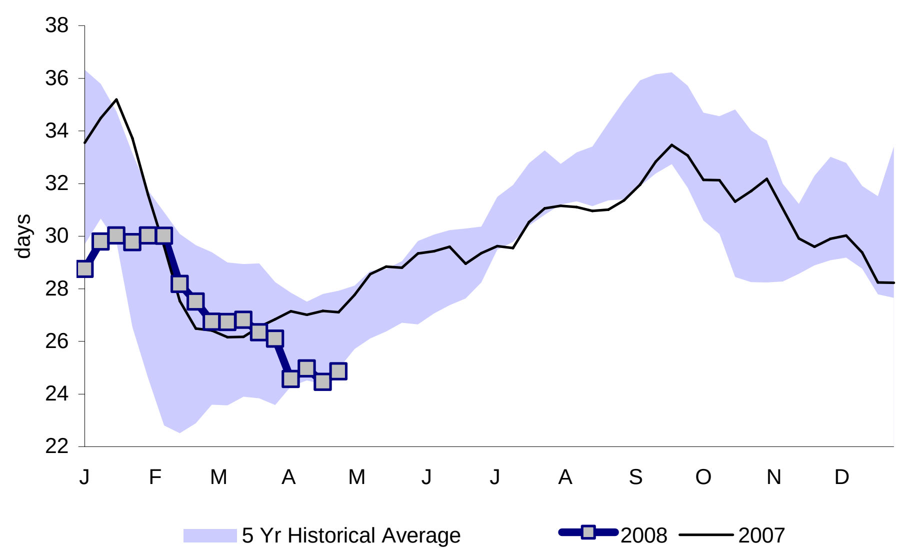
Source: Bloomberg, Deutsche Bank

Why is diesel at a premium?

Shifting trends in global growth

Diesel has historically traded at a discount to gasoline here in the US, driven primarily by much stronger demand for motor gasoline. However, recent global trends have pushed diesel to a premium to gasoline, a trend that is likely to hold for the foreseeable future. Again, this is the result of supply and demand. The dieselization of the automobile fleet in Europe has seen diesel demand significantly outpace that of gasoline. Strong growth in international economies, both in terms of transportation and industrial demand has exacerbated the balance. And while high prices have weakened consumer demand for gasoline here in the US, global industrial demand has remained relatively strong. The result has been a significant tightening in global diesel markets, drawing down US and other OECD nation inventories.

Figure 10: US distillate demand days forward cover

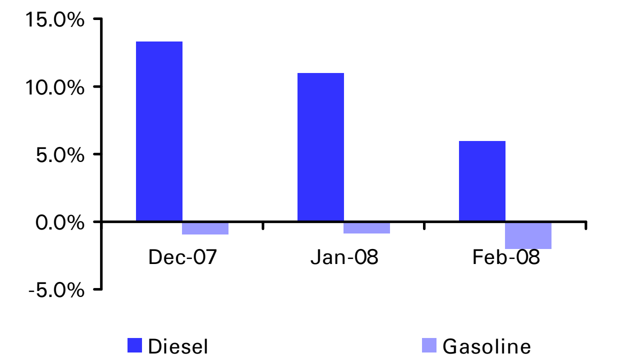


Source: US Department of Energy – Energy Information Agency, Deutsche Bank

The government mandated switch to Ultra Low Sulfur Diesel (ULSD), while not having a tremendous impact on supply, has certainly increased the cost of production and limited refinery flexibility in manufacturing product.

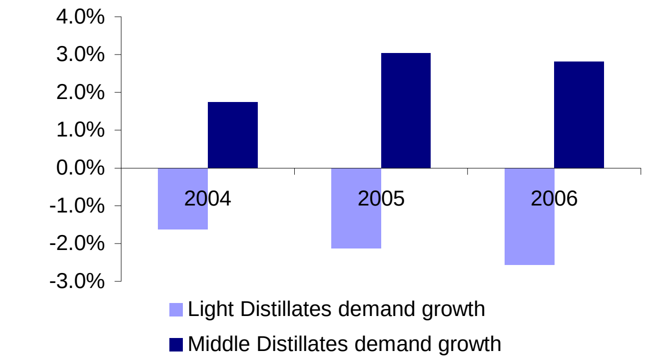
The dieselization of Europe, as well as the growing economies of developing nations around the world has driven strong growth in diesel demand. These nations tend to be structurally higher users of diesel relative to gasoline, both as part of the automobile and trucking fleets, as well as for power generation. Strong global demand, combined with a government enforced tightening of supply has pushed diesel prices to new highs relative to gasoline, with neither trend likely to be reversed any time soon.

Figure 11: US diesel demand outpacing gasoline



Source: US Department of Energy – EIA, Deutsche Bank

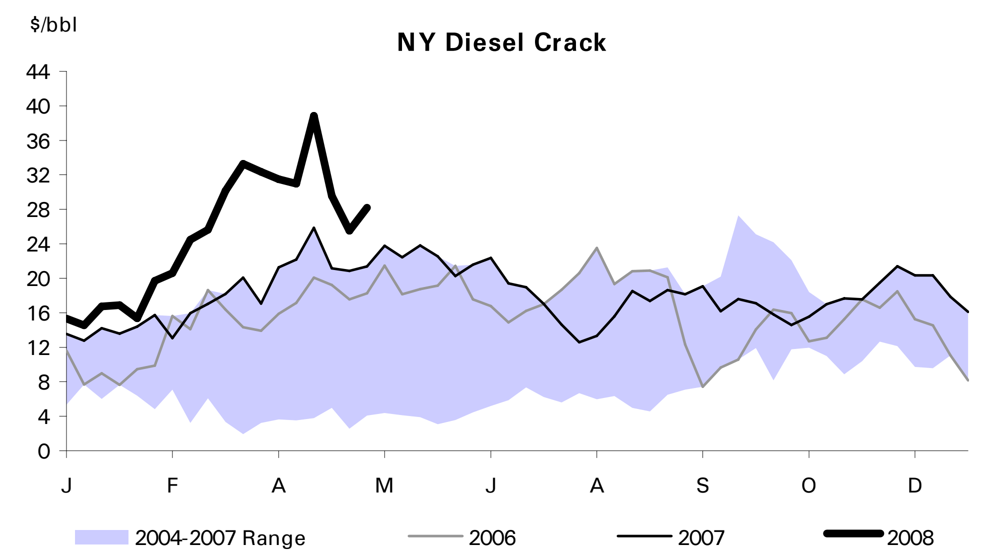
Figure 12: …and Europe is even more pronounced



Source: BP Statistical Review

As a result, diesel margins have been much stronger than historical averages.

Figure 13: US Gulf Coast Diesel refining margin



Source: Bloomberg, Deutsche Bank

As with all things, time and capital have a way of solving the problem. There is little that the industry can do in the short term, as refineries are maximizing their diesel production for obvious economic reasons. But, currently underway in the United States, and around the globe, refiners are investing to maximize diesel capacity (ie. Marathon's Garyville Refinery expansion).

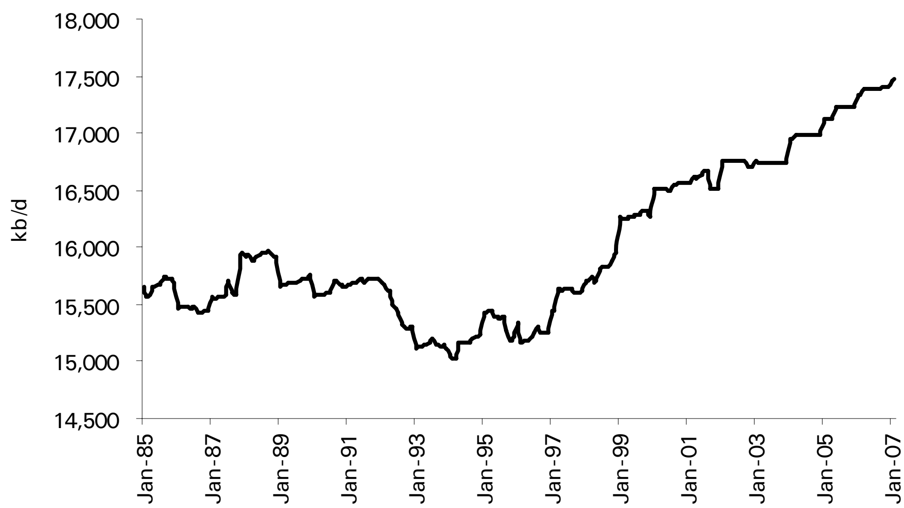
Myths

There are three key myths for policy makers to keep in mind.

Myth: US refining capacity is not growing

While a new refinery has not been built in this country for decades, plenty of refining capacity has been added. The chart below depicts US refining capacity, which as grown steadily since the mid-1990s. US refiners are adding capacity and have significant projects planned out into the next decade.

Figure 14: US refining capacity



Source: Department of Energy-Energy Information Agency, Deutsche Bank

Myth: High gasoline prices are bad

Gasoline consumption is widely viewed as excessive on the basis of energy security and environmental concerns such as global warming. As discussed previously, over the long-term, the only proven effective way to slow gasoline (oil) consumption is through prices. Given this fact, high gasoline prices can be viewed as a friend to the policy maker.

Myth: High gasoline prices are caused by price gouging

In a rising gasoline price environment, oil companies tend to lose money at the petrol pump, because cost of supply is outstripping price of sales. In fact, spectacular profits for gasoline marketing (the service station) are made in rapidly falling price environments. In neither case do we believe there is systematic price manipulation on the part of the major oil companies.

Appendix 1

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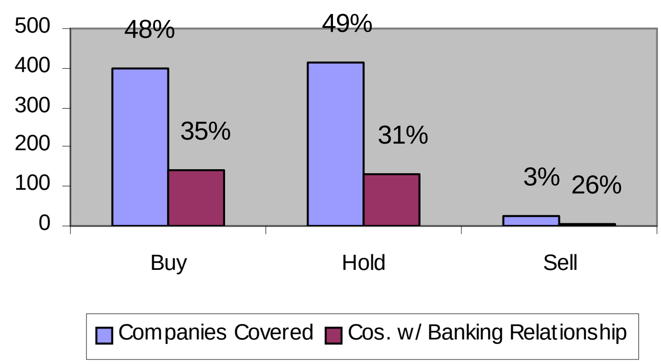

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